MARQUETTE BUSINESS REVIEW

A JOURNAL OF FUNDAMENTAL BUSINESS PRINCIPLES

APRIL, 1960

TABLE OF CONTENTS

Volume IV Number 2

Published by Bureau of Business and Economic Research
Robert A. Johnston College of Business Administration
Marquette University Milwaukee 3, Wisconsin

MARQUETTE
BUSINESS REVIEW

A Journal of Fundamental Business Principles

Published February, April, June, October, and December by the Bureau of Business and Economic Research, Robert A. Johnston College of Business Administration, Marquette University, Milwaukee 3, Wisconsin.

SUBSCRIPTION PRICE $2.00 PER YEAR

Single Copies $.50

CAPITAL SUPPLY IN THE NORTH CENTRAL REGION

Orange A. Smalley*

The Role of the Northwestern Mutual Life Insurance Company in Providing Investment Funds in the Period 1857 to 1897.

During the first forty years of its existence, the Northwestern Mutual Life Insurance Company collected $174 million in premiums from policyholders (to whom it sold insurance), earned an additional $52.8 million in interest and rent on its reserves (for example, the accumulated receipts invested for policyholders), and expended a total of $127.3 million upon such things as policyholder benefits and dividends, marketing and investment activities, record keeping, administration, and taxes. The almost $104 million of assets owned by the company at the end of 1897 represented the net investment in United States government bonds, bonds of various municipalities in the United States, farm and urban mortgages, and real estate made by the company's managers over the entire forty year period.[1] Over the course of this time span, the bulk of this investment was concentrated in the states of the East and West North Central Census regions. It can therefore be regarded as part of the net capital formation within this area.

Sums of this magnitude, while significant when attributed to the efforts of a single institution, are actually small when measured against the huge public and private investment made in the North Central regions between the beginning of the Civil War and the close of the Nineteenth Century. If sheer size of the capital formation in the Middle West were the sole criterion for papers presented at this conference, this paper would not have been prepared. What is important about the efforts of a single financial institution in contributing to the supply of capital in a region of rapid economic growth lies in showing how such an institution performed its role as a mobilizer of funds and as a distribution agent of capital. The primary objective of this paper is to set up a model which can be used as a guide for researchers who obtain the records of banks, insurance companies, and other financial institutions in identifying, selecting, and treating data which can contribute to a fuller understanding and a more accurate measurement of the role of capital formation in various regions

---

* Dr. Smalley is Associate Professor of Marketing and Chairman of the Department of Marketing, College of Commerce, University of Chicago. This paper was presented at the Business History Conference, 1960 Session, held at Marquette University on February 27, 1960.

1. Approximately $4 million of this amount is attributable to increments in the value of certain assets.

within the United States. This information, when utilized with the efforts of organizations such as the National Bureau of Economic Research, should provide new and useful concepts in the integration of economic history and economic development.

The Region, the Company, and the Era

Life insurance companies, using the modern definition, were little more than a decade old when the Mutual Life of Wisconsin -- the original name of the Northwestern Mutual -- was founded in Janesville in 1857. The primary function of a life insurance company was to furnish a means whereby individuals could systematically accumulate funds through their own savings to provide for themselves or for specifically designated beneficiaries. Only part of the annual installment (premium) went into this savings pool, for some fraction had to be allocated to pay for the risk borne by the insurer and for meeting the insurer's necessary expenses. The risk, of course, arose from the guarantee of payment of the face amount of the policy contract whether or not sufficient funds had been received from the insured to meet the obligation in full. The portion of the annual installment remaining after these allocations were deducted was the contribution to policy reserves; it was this amount, cumulated for all members of the insurance plan, which insurance company managers sought to invest. The safety of this fund was the first consideration, but certainly not the only determinant of its administration. If the fund could be so employed that the money it earned might be credited to the policy-holders who had contributed it, the out-of-pocket cost of the insurance could be reduced for the individual insureds. While the principal function of the life insurance company was to furnish a vehicle whereby the individual could contribute to his own security, or that of others dependent upon him, the effective performance of this function in a competitive society required that it become a skilled and careful investor. In short, the company functioned as both a mobilizer and distributor of investable funds, and it is with these roles that we are concerned as students of capital supply in the Middle West.

Wisconsin was the last of the five states of the East North Central region to be admitted to the Union. By 1857, nine years after admission, its population exceeded 500,000; that of its principal city, Milwaukee, numbered over 45,000, making it twentieth in size among American communities. Two railroad lines then connected the thriving port towns on Lake Michigan with the farms and villages on the Mississippi. This transportation contributed greatly to the rapid settlement of southern Minnesota and upper Iowa, and to the agricultural development of the whole region. Until 1861, Northwestern Mutual was a purely local institution, its sale of insurance confined to Wisconsin residents and its investment activities limited to accepting the promissory notes and cash offered in payment of premiums.

Between 1860 and the end of the Civil War this parochialism gave way to regional and then national expansion in marketing life insurance, and to regional investment development. Between Appotomox and the close of the 'Sixties, Northwestern agents were actively competing with the principal insurance companies of the East in all the most populous and

more economically advanced regions of the re-United States, and in some of the remote territories between Colorado and California. Only in the Gulf States and in the lowland portions of the lower Mississippi, South Carolina, and war-ravaged Virginia did Northwestern fail to push the sale of its insurance. These localities were considered substandard by the actuarial criteria of the day. The company's geographical investment pattern, however, was decidedly regional in character, with only a relatively small holding of United States government bonds and the portfolio of premium notes breaking the pattern. The magnitude and distribution of these promissory notes were, of course, a function of the volume and distribution of insurance sales. Approximately 38 per cent of Northwestern's $6.6 million in assets were mortgage investments, and the greatest proportion of these were on Wisconsin property.

The investment pattern which Northwestern evolved during these formative years followed directly from the company's basic policy of earning the highest rate of return commensurate with safety. The nature of the type of investments the company could make was limited by its charter and by economic opportunity, including the state of the national technology. The company was permitted to make loans on improved real estate "up to one-half the value of the appraised property," to acquire real estate necessary in the conduct of its business, and to purchase the bonds of the United States as well as those of the State of Wisconsin and of communities located in the state. These conditions were later modified to permit the acquisition of similar assets located in other states and territories in the Federal union. The loan provision enabled the company's officers to invest in the mortgages on industrial and commercial enterprises as well as on farms and private residences; if Northwestern was prohibited from purchasing the securities of railroads, of banks, and of industrial concerns, its officials were not chagrined. Investment in such economic activity was highly risky during these early years, and the gains accruing to such investment were matched by those taking place in the real estate of rapidly growing communities.

Real estate mortgages were to prove an excellent investment for the funds of a life insurance company, and this was particularly true during these years in many of the states in the North Central region. The reasons are not difficult to identify. The rate of population increase in this region was almost double that of the country as a whole, and was exceeded only in the Pacific and Mountain states. Between 1850 and 1880 national population grew from around 23 million to over 50 million; that of the northeastern states rose by almost six million to 14.5 million people; the southern states increased from nine million to 16.5 million; the Far West from 200,000 to 1.8 million; and the North Central region rose from 8.6 million to 14.5 million. A basic theoretical formulation in economic development infers that the growth of population in a resource-rich, labor-rich area should result in a rising rate of marginal productivity per unit of input. Scattered data for wealth, income, and the physical volume of output, railroad shipments, number of industrial concerns, estimates of value added, and wages paid, indicate that this was precisely the pattern which occurred in the North Central states

during the three decades ending in 1880.[2] The steady increase of population, expansion of the transportation network, particularly of railroads, and the establishment of new farms, new manufacturing, extractive, and distributional enterprise combined to increase output and to cause a steady -- sometimes spectacular -- rise in real estate values. Since Northwestern was not permitted to purchase land or buildings for investment, the company could not directly benefit from such increment in land values. But other interests could so benefit by real estate improvements, and Northwestern could and did lend to such developers and businessmen. The increment in land values generally protected the company since, in the event of foreclosures brought about by temporarily adverse economic conditions, company officers could count on long-run recovery of values. Equally important, the income opportunities on well-located real estate were high, thereby enabling borrowers to pay high rates of interest for scarce capital. During its initial decade of operation Northwestern typically obtained interest rates of 9 per cent, 10 per cent, or more, for lending on well secured mortgages, and during the 1870's the mortgage earnings rate was over 9 per cent.

Now during the early years, company officials were concerned with two interests. The first, in view of the responsibilities of trusteeship, was the security and earning capacity of investment. Clearly, mortgage investments made on carefully appraised property contributed to the goals of security and substantial returns since company trustees and officers could frequently make the appraisals themselves, and there was a general familiarity with the economy and property values in the state. The second was the element of self-interest. In a mutual company, no incentive to effective management by owners existed, as occurred in proprietorships, partnerships, or small corporations through the profit motive. There were, of course, jobs within the company if it prospered and grew, but for many of the Northwestern trustees, their primary interest lay in the increment of land values and the stimulus of economic activity which was generated by the flow of new capital into Wisconsin towns and farm areas in which they already had business interests. While the development of Northwestern's insurance business during the years after the Civil War, the flow of premiums quickened in tempo and more often appeared in cash form. Thus, the rate at which new mortgage investments could be made was accelerated.

During the last part of the 'Sixties and early 'Seventies, however, a new investment problem arose. The company's sales manager at the time was a highly aggressive promoter who was convinced that mortgage lending should be synchronized to the development of new business. He insisted that mortgage borrowers also be Northwestern policyholders; with the need for capital as it was, he had every reason to expect that buying life insurance would be a price to which most borrowers would readily accede. Such a practice, however, posed several inherent risks,

---

2. See Eighth, Ninth, and Tenth Census of the United States, 1860, 1870, 1880. Also, for example, see Bessie Louise Pierce, A History of Chicago, I, II (New York: Alfred A. Knopf, 1940).

not the least of which was a geographic dispersion of mortgage money into areas where company officials were relatively ignorant, and where the pressure to sell insurance could adversely influence sound investment judgment. There was also the danger that a substantial proportion of funds would be lent in areas with the greatest policyholder concentrations, such as New York, Pennsylvania, and New England, where interest rates were lower than in the North Central region. After several temporary compromises, this practice was finally rejected in a hard-nosed showdown. Thereafter, Northwestern marketing was cleanly separated from investment practice, a policy which was strengthened during the late 'Seventies by the adoption of a branch office system of salaried loan agents under the administration of a home office investment officer. It is of more than passing interest to observe that not a few of the life companies which bankrupted in the depression following 1873 had adopted policies identical to that which this company rejected.

By 1873 mortgage loans comprised 56 per cent of Northwestern's $14 million of assets; 40 per cent of this was on Wisconsin real estate, and almost another 30 per cent was on property located in Illinois and Indiana. During the rest of the decade, mortgages increased in importance until 1877, then declined relative to the total investment until by 1880 they constituted just 54 per cent of $18.4 million of assets. Among the effects of the economic depression that characterized the decade was a rapid slowing down of Northwestern's growth in both insurance and investment. In fact, during 1878 both assets and insurance in force declined absolutely, then recovered. Northwestern suffered its first mortgage foreclosures and the dollar value of properties taken under foreclosure rose almost $2 million, or over 9 per cent of assets. With the sharp reduction in mortgage lending opportunities of the quality which the management insisted upon, the company had to seek alternative investment opportunities. In part they found these by the purchase of United States government securities and in the bonds of incorporated municipalities in different parts of the country, particularly the Middle West. The aggregate of such securities in the portfolio was about $2.5 million in 1880, about 14 per cent of assets. Furthermore, the rate of interest fell as demand for capital abated more rapidly than supply.

The company emerged from the depressed 'Seventies in excellent financial condition, however, and with some revised investment policies. The branch loan office system was broadened and strengthened; the disappointing experience with farm foreclosures and the slow recovery of the farm market caused a pronounced shift toward urban lending; and the interest rate pattern was modified, both by the national trend and by the intensified investment effort being made by Northwestern in the urban real estate markets. In the latter they encountered strong competition from other insurance companies and other financial institutions, a competition which tended to push interest rates down. The geographic concentration of mortgage loans became even tighter over this period. As indicated by the table below, the states of the North Central region commanded between 96 per cent and 98 per cent of all Northwestern loan money over the seven years ending in 1880. Heavily populated New England received none, and less than $50,000 was ever invested in the Middle Atlantic region. By 1880 the combined mortgage investment in

the southern states was under $150,000, and this in only a few cities. West of Nebraska, only Denver was considered good loan territory, and this city received under $150,000.

TABLE 1

REGIONAL DISTRIBUTION OF NORTHWESTERN MUTUAL MORTGAGE LOANS, 1874 TO 1880

(As a percentage of total mortgages)

Geographic Regions	1874	1876	1878	1880
New England-Middle Atlantic	0.0%	0.0%	0.0%	0.0%
South Atlantic-South Central	3.7	2.8	1.6	1.3
North Central	96.6	95.9	97.4	98.0
Mountain-Pacific Coast	0.7	0.7	1.0	0.6
Total (in millions of dollars)	$9.5	$11.6	$11.5	$10.0

But this paper is ostensibly directed to an examination of Northwestern Mutual as a mobilizer of and investment agent for capital funds. I have provided the foregoing simply to set the background which I believe necessary for us to comprehend the company's role as a capital transfer agent during these initial twenty-odd years of its life. Investmest policy and the pattern of concentration of investment geographically, together with their national marketing practices provide a necessary analytical apparatus in a measurement of capital formation through the company.

Because of the paucity of data before 1881, the problem of measuring the flow of money from different marketing regions to the area of principal investment is most difficult and only the roughest approximation can be made. But we can make this approximation and also provide a rough estimate of the quantity of internal capital formation -- internal to the investment areas. Up to the end of 1880 Northwestern received in premium income a total of $37.4 million. Over this same time period it disbursed $25 million in direct payments to its policy holders in death claims, matured endowments, surrenders, and dividends; and a further $5.3 million in agents' commissions, medical fees, advertising, legal and legislative expenses, hotel and travel expense, and taxes. Presumably these outlays remained in (or were returned to) the geographical areas from which premiums had been collected, regardless of the time lapse. The difference between these two amounts, premiums and local outlays -- $7.1 million -- can then be viewed as a transfer from the locations wherein they were collected to the home office in Milwaukee. From this amount home office expenses such as salaries, rental charges, equipment, supplies, and administrative costs have to be deducted to measure the net amount available for investment from premiums. The aggregate of all home office costs for these years was $2.1 million, leaving $5 million available for investment. To this is added total investment earnings of $12.8 million giving a total of $17.8 million invested by Northwestern

by the end of 1880. Increases in the book value of assets of $500,000 brought the company's total asset account to $18.35 million.

As to how much of this amount was contributed from within the North Central states, and how much of it flowed into this region from outside, particularly from the better endowed states of the New England and Middle Atlantic regions, no precise figure can be presented. We know, however, that before 1867 only Pennsylvania and Massachusetts in the east, Colorado, and the eastern portions of Alabama, Kentucky, and Tennessee had been invaded by Northwestern insurance agents. Since Northwestern's assets at the end of 1866 were $1.7 million, it is a conservative estimate that between 80 per cent and 90 per cent of this amount had been contributed by North Central policyholders, or roughly $1.5 million. If we consider the possibility that, in the absence of buying life insurance, these policyholders would not have saved this amount of money -- and this view is reinforced from evidence on the quasi-forced savings nature of life insurance -- we can consider this amount of capital, small though it is, a contribution to Middle Western capital formation which would not have been made in the absence of Northwestern Mutual. An alternative is that these policyholders would have purchased insurance anyway, but in this case, since the overwhelming proportion of life insurance was sold by Atlantic Coast companies, there is every reason to expect that the funds would have been lost to the region, since most of the big eastern firms confined their investments to seaboard states.

Following 1866 the relative contribution of North Central policyholders to the total premium receipts of Northwestern -- and the corresponding proportion of total assets attributable to this contribution -- diminished. The multiplication of Northwestern general and state agencies on both coasts was the fundamental reason for this change, particularly in New England and New York where greater population density and a higher level of industrialization existed. For the fourteen years ending in 1880 the company received $33.6 million in premiums, paid $29 million in policyholder benefits and locally attributable costs, and funnelled $4.6 million into Milwaukee. After home office expenses were deducted, $2.6 million was available for investment. To this was added $12.6 million of investment income for a total of $15.2 million, the aggregate net investment for the period. Basing these estimates on data which were first published in 1882, and extrapolating for earlier years, we may infer that policyholders residing outside the North Central region contributed between 20 per cent and 30 per cent of total net premiums for this whole period. The residual flow of funds from all these regions to Milwaukee must then have been in the range from $920,000 to $1.38 million; and net contribution to investment after deduction of the pro-rata administrative expenses to between $520,000 and $780,000.

The contribution of these non-North Central policyholders to total Northwestern assets at the end of 1880 was probably less than their respective contribution to net premiums. A conservative estimate would be between one-sixth and one-fourth. If we impute this proportion to investment earnings, we would have to credit them with between $2.1 million and $3.2 million in indirect capital contributions. For the entire period 1857 to 1880, then a good estimate of the net contribution of capital

from the Atlantic seaboard states to other sections of the country, principally in the North Central region, was between $2.9 million and $4.2 million, through Northwestern Mutual alone. This estimate is, of course, based on the assumption that Northwestern insurance, by types of policy contracts, were distributed normally over the entire market, and that easterners did not suffer disproportionate incidence of mortality, surrenders, and so forth. It must also be concluded that policyholders in the North Central region contributed between 50 per cent and 60 per cent of the total capital accumulation of the company at the end of 1880, or between $9 million and $11 million, directly and indirectly. The remainder of investment capital was forthcoming from the South and the Far West.

During the period while undertaking active research in the voluminous records of the Northwestern Mutual, the writer fortunately discovered data on premiums paid the company by states. This series, which began for the year 1881, listed only first-year premiums. Putting together the first-premium data with information on the amount of insurance in force, which was also limited by states, provided a means of forming an estimate of total premiums paid by states and territories. A ratio of first-year premiums to new insurance issued was computed for the years 1882-1897; so also was a ratio of first-year to total premiums, and one for life insurance sold to insurance in force. By successive approximations a smoother ratio of premiums paid to insurance in force was estimated on a state-by-state basis, and the states aggregated by regions. The method is, of course, subject to several kinds of error, but the writer believes it sufficiently accurate to provide a reasonably precise estimate of total premium formation on a regional basis.

The company's annual statements also provided itemized accounts of all expenses incurred and all payments made to policyholders. These items were then pro-rated to the regions on the basis of insurance in force data for individual states, assuming symmetry for the distribution of policies by types. Investment data were also available for all these years, with the most detailed information contained in the quarterly and annual reports contained in the Minutes of the Executive Committee. Mortgage loans by states, purchases of municipal securities, changes in real estate accounts, and so forth, were all clearly indicated. Only premium notes and policy loans were not given in such form that a direct inference as to geographic location could be made. This was handled on the same basis as was the allocation of policyholder benefits, that is, according to the ratio of the insurance in force in the individual states to the total. Thus, except for policy loans, accurate and direct information with respect to investments was available annually on a state-by-state basis.

A schedule was then organized on a regional basis. The estimates of total premiums paid in the several regions was entered, and from this was deducted the estimated amounts paid out locally with the respective regions to policyholders in benefits, to agents, medical inspectors, in taxes, and so forth. The difference was identified as the amount net to Milwaukee before regional investment was accounted for. Then the net investment (or disinvestment) in the region during the year was

subtracted from (or added to) this net amount due Milwaukee. The sum or difference was identified as "the flow of funds from (or to) other regions." The writer set up three major premium paying investment regions. Region I consisted of the New England and the Middle Atlantic states, and the South Atlantic region excepting only Florida and South Carolina. Region II comprised the states of Illinois, Indiana, Michigan, Ohio, and Wisconsin. Region III consisted of the seven states of the West North Central states, plus Colorado, Kentucky, Tennessee, and Alabama. For the entire seventeen years, 1881 to 1897, estimates on premium formation, net investment in respective regions, and net flow of funds in or out of regions, was:

TABLE 2

CAPITAL FLOW CHART: NORTHWESTERN MUTUAL, 1881 TO 1897

	Gross Premiums	Net Before Investment	Net Regional Investment	Net Flow of Funds to (+) or out of (-) the Region
	(In millions of dollars)			
Region I	$ 46.0	$15.2	$ 4.1	- $11.1
Region II	40.2	9.6	41.0	+ 31.4
Region III	29.2	9.8	27.6	+ 17.8
Other	21.3	7.4	9.3	+ 1.9
Total	$136.7	$42.0	$82.0	+ $40.0

We can thus see that the Atlantic seaboard states contributed a total of $11.1 million in direct net cash flow to other regions for the period. Not all of this, of course, was investable funds, for the proportionate share of home office expenses had to be deducted. The company's investment in these states increased by $4.1 million, but this increment did not take place until the last three years of the period; for the first fourteen years there had been a net disinvestment of $50,000. On the other hand, the net investment in the North Central states was in excess of $64 million, with Colorado, Tennessee, and Kentucky receiving about $4.5 million. All other geographic areas received $9.3 million in investment funds, including mortgage loans but consisting mainly of policy loans and purchases of municipal bonds. In fact, if the previous conception of crediting the policyholders of all states with a share in investment income proportionate to their share of the company's total assets is followed here, the Atlantic seaboard regions made a gross contribution of capital to the other regions of the country of approximately $25 million. This is based on the assumption of attributing about 30 per cent of gross investment income to the policyholders of these states, amounting to about $13.8 million.

Summary:

During the first forty years of operation, Northwestern Mutual Life Insurance Company passed quickly from a local market to a regional market, and then into the national arena. The investment development, however, tended to be highly regional in terms of the concentration of assets. By 1870 mortgage loans were the preferred type of investment for Northwestern's managers, such securities providing a high degree of safety and excellent earnings. From 1870 to 1897 Northwestern had 90 per cent or more of its mortgage investment concentrated in the twelve states and territories of the North Central region, and the geographical distribution of its municipal bond investments until the middle 1890's closely parallelled this concentration. The company established a policy clearly separating the insurance from the investment business, and its policy of concentrating its mortgage investments was determined by the higher rates of interest to be earned, and the steady increase in real estate values in its preferred loan territories such as Iowa, Illinois, Minnesota, and Wisconsin. Eastern seaboard states were considered inferior investment territories during these years before the era of industrial and transportation consolidation. Atlantic coast farms were prosperous, but their limited size required more and smaller-sized loans to be made than Northwestern's managers found economical, certainly less so than was true on the larger farms of the Middle West. Real estate investment on the larger eastern communities was avoided because the greater supply of investment funds available there depressed interest rates. On the other hand, investment in the southern and far western states was limited to mortgage loans on urban property in certain cities despite the higher rates offered for farm loans. Company managers were suspicious of one-crop agriculture and the land-mining practices in the South, and the dry farming of the West held no allure.

During its initial decade of life, Northwestern collected the bulk of its premium income from within the North Central region, stimulating savings into pools of funds which, when shrewdly employed, contributed to the economic development of the region. Coincidentally, the higher rates of return the company was able to earn by its policy of Middle Western investment, combined with the company's low expense operation, permitted its policyholders to acquire insurance for a lower net cost than could be obtained from most of the company's competitors. Following 1866, however, Northwestern became much more than a mobilizer and pooler of locally accumulated funds. Following its rapid market expansion and the aggressive exploitation of new sales opportunities, the proportion of the company's total insurance in force held by non-Middle Western residents rose to around one-half by the end of the era, and approximately 50 per cent of its premium income from 1880 to 1897 was contributed by policyholders on both the Atlantic and Pacific Coasts, and from other states and territories lying outside the North Central region. It has been estimated that directly through payment of net premiums, and indirectly through the reinvestment of interest and rents earned on their policy reserves, that policyholders in the Atlantic seaboard states contributed over $30 million of investment capital to other geographical regions, particularly the North Central states.

It is also apparent that premiums collected from policyholders in capital scarce regions were funnelled into regions where capital was more plentiful, a form of "colonialism" which has been bitterly denounced by the residents of such areas, particularly ambitious politicians and local businessmen. This case is extremely interesting and is worthy of more detailed exploration.

With respect to important and interesting factors in economic theory and economic development, then, the role of Northwestern Mutual in the formation of capital in the North Central states merits close attention. In addition to setting an example of how individual firm histories can provide the kind of data that sheds light on the mechanics as well as the magnitudes of capital formation and capital flow, it provides a neat example of the self-interest model that was so dear to Adam Smith. Here were many individual policyholders, each seeking to maximize his own or his dependents' security through life insurance; there were company trustees, agents, and officers seeking to maximize careers, salaries, commissions, and prestige; beyond were other individuals seeking to maximize the production of some product, the exploitation of some resource, and needing capital to achieve the goal. Yet all were combined in various ways by the agency of Northwestern Mutual to contribute to the economic development of the Middle West during a period of its most important growth. In the process it is unquestionable that more people had the opportunity to improve their material lot than would have been the case without the company.

HOW ARE PRODUCTIVITY GAINS TO BE SHARED?

Cono Casella*

Much has been said about productivity in recent years. Consequently, discussions as to what it amounts to for particular industries or for the economy as a whole, the relative part played by various economic groups in making such gains possible, and -- touchiest of all -- how the increased earnings are to be shared have become matters of widespread interest. The steel strike of 1959 can be said to stem from arguments of labor and management surrounding productivity issues, both with regard to the share to go to labor as well as managerial freedom to modify work rules to better industrial efficiency. Similar disputes are likely to crop up with increasing frequency in the future. This can be expected because of the accelerated rate at which new methods of production are being resorted to in the manufacture of old and new products.

How, indeed, are productivity gains to be shared? Can this vital issue be left to established techniques, mainly competition among producers for consumer acceptance and collective bargaining to determine conditions of employment? Or must the rules whereby the tug-of-war among consumers, manufacturers, and labor is carried out be changed to avoid some of the more wasteful side efforts of these methods? Finally, if a change is desirable, what considerations should be taken into account to help arrive at a more widely accepted manner of distributing the fruits of economic effort?

In spite of frequent use, the term productivity and its measurement are still not agreed upon by those who employ them. Generally speaking, productivity refers to the ratio between the sum of effort and materials required to turn out given products for the market place. The difficulties of measuring this relationship arise from several major sources. Perhaps the most obvious is the many different ways in which labor, capital, and resources are employed to produce the great variety of goods and services we purchase. The number of workers and skills needed, the quantity of capital used and how invested, and the application of managerial skills to arrange these factors to transform resources into specific products vary from firm to firm, from industry to industry.

Other biases that distort the statistical data applied to obtain information regarding productivity are even more difficult to evaluate. Of these, two problems in particular deserve mention. The full cost of industrial activity is not included. Social costs, such as the disadvantages of living in over-crowded cities, the pollution of streams and air, and

---

* Dr. Casella is Associate Professor of Economics, Long Island University, New York.

the consumption of resources that cannot be replaced are among the items not listed. Then the full measure of improvements contributed by industrial activity is understated. This includes such elusive advantages that flow from an abundance of different products to choose from, better quality, improved style, and the creation of new things that did not exist before. There may be things we would just as soon do without, but there are others, like the wonder drugs, improved communications and transportation, and myriads of other products that have helped make life better.

Furthermore, the range of annual rates of improvement for various industry groups is startling. According to Bureau of Labor Statistics computations, the real product per man-hour in agriculture more than doubled from 1947 to 1958. The improvement amounted to about one-third in manufacturing, and about one-quarter in the remaining industry groups for the same period. Not all industries within these groups are performing in the same way, however. Some are improving their productivity at less than the average rate, while others are above it. Finally, the individual forms that are included in each industry vary a great deal. Some are models of efficiency, with highly competent management and possessing the latest equipment that is run by a work force that enjoys high morale. Others may be marginal companies that are on the verge of closing up shop.

These variations in the performance of individual companies stems in part from the behavior of the persons who run them, but not all of the differences spring from this source. Those industries that have reached a high degree of development cannot reasonably expect to continue to make giant steps unless some technological breakthrough brings with it radical changes in the process of manufacturing. Then there are new industries or new products that have plenty of areas in which to introduce improvements. Moreover, the fortunes of the individual firms are also influenced to some degree by the geographic area in which they are located. Those placed in rapidly growing parts of the country will have a better chance to do well than those in stable or declining areas. In addition, changes in consumer preferences can play havoc with the best laid plans of company directors. All of these factors create influences over which labor and management may have only limited control.

Nevertheless, by dint of arduous effort and not a few heroic assumptions, it has been possible to arrive at workable methods to measure productivity. Now, any factor that contributes to the finished product may be used as a yardstick to indicate improvements in over-all effort. By practice, the amount of labor in terms of hours or days of work is preferred because human effort is the basic element of production. Since the ultimate purpose of all economic activity is the satisfaction of human wants, what better way to underline this fact than to base the amount of work as the means of measuring changes on productive ability? This is not to say that labor is necessarily the most important factor, or the only one responsible for these improvements, however.

Another caveat is also in order. The approximate nature of this yardstick, and the distortions introduced by business fluctuations, make it advisable to use the yardstick with caution and only for fairly long

periods of time. According to an estimate made by Professor Solomon Fabricant, of New York University, labor productivity increased by an average of about 2 per cent per year from 1889 to 1958, compounded. Other studies indicate that a rate only slightly less was achieved during the balance of the last century. This may not seem much at first glance, but it amounts to a doubling of production every 25 to 30 years. That is, the volume of products turned out with a given time period of labor effort has tended to double roughly every generation, a rate of sustained economic growth probably without parallel in history.

It is paradoxical, therefore, that our good fortune should create disturbances. Granted this record, and assuming that the rate of growth will continue in the future, the question of how this greater basket of products is to be distributed among the various economic interests can be a source of much unpleasant bickering. Many of these contentions are concerned with the relative importance of and/or the best way of sharing the increasing supply of goods and services.

Labor, for example, holds that much of the gain in economic efficiency is due to its effort. This claim is based on the evident fact that the elaborate machinery and equipment of industry could not turn were it not for the workers who operate it. Moreover, as the manufacturing processes become more intricate, labor of an ever higher order of training and competence is required. In addition, the rapid pace at which economic changes are introduced is placing an extra burden upon workers, the demand for greater flexibility in adapting themselves to the new methods. Of even greater importance, as better ways of doing work are applied, jobs are wiped out. This state of affairs is especially evident in manufacturing activity. In 1946 there were 35 million workers employed by manufacturing establishments of all kinds. By 1956 this total was down to 32.2. A closer look at the number of production workers indicates an even greater reduction, from 29.3 to 24.8 million, while non-production workers (administrative and clerical) increased from 5.7 to 7.5 million during this period.

The sharp drop in the number of production jobs poses a serious problem for this group. If past trends continue, more and more production workmen may expect to lose their jobs. This may mean seeking employment in those industries that are growing, with all that this entails in learning a new trade and perhaps starting at a lower wage, or even changing location to move to areas of expanding opportunities. Greater adaptability is being demanded of labor. When this element of insecurity is added to already existing seasonal and cyclical fluctuations, it is easy to understand why claims for a substantial part of production gains rings a responsive chord among union members.

Management takes exception to the reasoning behind many of the efforts of labor to slow down economic change, to make as much money for less work, or otherwise to create job rights. The employers hold that owners of industry deserve a substantial slice of any improvements made possible by new or more expensive equipment. Unless industry can yield a reasonable profit to investors to obtain needed capital, it will be difficult to go into the money market to get the funds needed to

buy new or better equipment. This need is all the greater because of the rapid obsolescence of existing equipment, and the upward spiral of prices in the wake of the inflationary push.

Furthermore, industrial leaders insist upon the freedom to change or modify work rules as new equipment is put to use. Attempts on the part of labor to protect jobs by featherbedding or other restrictive devices reduces the incentives to promote using the best methods available to economize on the effort or materials required for production. True, this may mean loss of jobs or shifting around to obtain other employment, but these hazards are not spared the investor or businessman. Moreover, we live in a world in which resources are scarce and are becoming more so, as the more readily available national deposits are mined out, and competition for other sources in the international market becomes more hectic with the rapid industrialization of nations that formerly made no demands upon them.

Featherbedding is an example of deliberate waste of irreplaceable economic potential. A far-fetched case can be cited to suggest the inadvisability of employing such methods to protect particular jobs. At the turn of the century, there were any number of untamed diseases that killed off a substantial number of children. Thanks to the advances in medicine, the mortality rate has been pushed down. Of course, gravediggers, coffin manufacturers, and undertakers were deprived of much of their employment in the process. Should the saving of lives have taken a second place to protecting the jobs of these people? It would have been folly to withhold improvements in health care just to save the job of gravediggers. Instead, the growing number of those whose lives were saved created new demand for clothing, food, shelter, and all the other products we are accustomed to. Other jobs were created elsewhere for the unemployed gravediggers.

This is not to say that concern for those whose work is abolished by new and improved machinery is unwarranted. Although the nation as a whole benefits from greater economic efficiency, it may create special problems for the groups or regions affected. Finding new jobs or attracting new industries is not always an easy task. Market imperfections, however, do not mean that other rigidities to adjustments should be introduced. It is better to take steps to alleviate cases of hardship rather than to introduce arbitrary make-work schemes that raise prices, and, at best, can only make for costly delays in finally effecting changes in production.

Keeping up American industrial efficiency means a great deal more than creating profitable situations for the more successful firms. Our economic leadership is being challenged at home and abroad by producers in the free world, as well as in communist controlled countries. If the United States is to maintain its lead in at least part of industrial production, it is necessary that the economy accept new developments rapidly. The growing competition from other countries makes it rank folly to drag our feet in improving production just because some workmen or investors might be adversely affected. A sound and efficient economy is a must in this period of cold and threatening hot wars. Without it, our way of life may be extinguished.

A growing awareness of the issues at stake probably accounts for the much stronger stand being taken by management, especially in those industries frequently accused of caving in too easily to union pressure in the past. Industrial leaders are rebelling against the accumulation of restraints and wasteful work rules that may go back many years, as in the railroad industry, or may be of more recent vintage, as in the newly organized mass production group.

Productivity gains, therefore, have a tendency to upset established methods of production, whatever their benefits. In view of all these complications, it would take an extraordinary insight to determine accurately just what the contribution of the various groups involved may be, and the part played by largely fortuitous circumstances. But even if this miracle of precise calculations were achieved, it would tell only part of the story. The entire community functions as a unit rather than as collections of individuals able to do what they please without regard to all the others.

Each of us relies to some degree upon everyone else. A particular instance may help to clarify this statement. A steel mill will have a certain rate of production with its given labor supply, capital investment, and managerial leadership. This mill is not an isolated island, however. The flow of materials to the plant is made possible only by a grid of roads and railroads provided and supported by others. The production workers can perform their tasks well only if they are provided with adequate supplies of goods and services to meet their needs for shelter, clothing, food, and all the rest. This extends from the grocer, the doctor, the school teacher, the fireman, the policeman, and all the others who contribute directly or indirectly to the operation of the steel mill. Of course, the steelworker helps out the others as well by his part in the economy. What is important to remember is the very close interrelatedness of each part of the community with all the others. Therefore, productivity gains are not won by management or by investors or by labor alone in the particular industry, but to some degree by the entire economy and community. For this reason, the consumer deserves something as well to reward all the others who participate in the effort to raise the general economic efficiency.

By now it must be apparent that there is no easy answer to the question of how productivity gains are to be distributed. This is not a counsel of despair, but recognition of the full complexity of this issue to warn against accepting too facile solutions. Leaving aside partisan claims and counterclaims, just what sort of rules are to be sought to insure a more balanced approach to this issue?

Three general considerations should be taken into account when this task is undertaken. The first of these is to elicit a high degree of cooperation and performance from those directly involved in economic activity, whether it be labor, management, or investors. The needs of others is next in order to provide an adequate distribution of income or lower prices for those too young, too ill, too old, or otherwise occupied. Finally, an attempt must be made to regulate the flow of goods and

services in such a way as to bring about a satisfactory rate of economic growth that is stable and adequate for present or future requirements.

The most pressing need is to obtain a high degree of efficient industrial behavior on the part of those engaged in particular firms or industries. Labor must be encouraged by direct or indirect payments to insure a competent, adaptable, and flexible work force. This extends to providing an incentive to promote the acquisition of skills, experience, and training such as to insure the availability and presence of labor in the correct numbers wherever and whenever needed. Attending to this task is not simply a question of paying more or less to different individuals, important though this may be because of the accent on material rewards. It can be aided or hindered by social prestige or esteem attached to particular work positions. Fair treatment is also important to raise morale. Finally, the attitude of employers in dealing with their employees can either facilitate cooperation or raise obstacles. Thus, labor needs the combination of rewards sufficient to provide the essential atmosphere of cooperativeness to perform its job well, and do it in spite of the occasional frictions and differences that may crop up from time to time.

Risk-taking can be encouraged, and conditions established that promote the effective functioning of the free market system. Only in this way can we be sure of obtaining the bulk of the products we want, when we want them, at acceptable prices without our having to resort to central planning. Translating these general rules into reality can no longer be done as before. The existence of strong labor unions, and the body of social legislation passed in the last twenty-five years has narrowed the range of freedom available to the business community. Nevertheless, it is possible to carry out management's task, as is evident from the remarkable performance chalked up since the end of World War II. This is not to say that restraints and restrictions can be added without limit.

If the United States is to retain at least part of the industrial leadership that is being challenged on all sides, then business cannot be stifled without harm to the economy. This inevitably requires close attention to those efforts essential to maintaining industrial capacity, and inviting that flexibility and risk-taking so essential to trying out new ideas. Unless the Russian premier is to be given the opportunity to wave to us as the Soviet economy passes us by, every encouragement should be given to promote a better and more effective productive system. Only in this way can we be sure of creating new jobs to keep up with the growing population and those rendered jobless by labor-saving devices. Only in this way can we be sure of having an economy capable of bearing the added claims being made upon it by union leaders, the international rivalry with Russia, and the rising numbers in our population.

The second major objective is more difficult to attain because it is not so noisily pressed. At one time conditions were more stable and less hectic, therefore the family unit was more or less self-reliant. With the advent of urbanization there has occurred a loosening of family ties. Industrialization has brought with it the hazards of unemployment, industrial diseases, and loss of employability with the coming of old age. A complex system of welfare laws have been set up to meet some of these

problems. In addition, the persons on relatively fixed incomes are quite often forgotten in the general arguments among the better organized economic groups. Finally, there are essential services which are frequently by-passed in the rush of labor and management to appropriate as much of the production pie as possible. These groups cannot be disadvantaged without calling into question the adequacy of the whole distributive arrangement of the economy.

The last of the three goals that need to be taken into account has to do with the wider impact of labor management behavior upon the economy. If the productive capacity of the nation is to grow at a satisfactory rate, then enough has to be set aside to expand investments or replace used-up equipment. It may be possible to consume a greater proportion of total output without concern for the future, but this usually brings with it an economy that shows neglect by falling efficiency. Hence, if a satisfactory rate of continued growth is to be attained, the demands of labor must be held in restraint so as not to discourage thrift or risk taking.

But economic growth is no longer enough. At one time business fluctuations were accepted as inevitable, to be borne in silent suffering. This is no longer the case. The public is becoming impatient with recurrent booms and busts, with all that they mean in loss of income and in human suffering. The way in which labor and management comport themselves can have considerable impact upon the entire economy. Major strikes, deliberate waste, or long-term wrangles may induce gyrations whose effects can extend well beyond the particular firms involved. If labor or management behaves in an irresponsible manner, this is likely to have a marked effect on related activities. In more serious breakdowns the capacity of the economy to function well may be harmed. These actions may not of themselves bring about depressions, but when added to other disturbances they do not help eliminate economic instability.

Abuses on the part of labor and management not only endanger the performance of the productive system, they also threaten what is probably the most precious attribute of the free market system, individual economic freedom. Whatever the shortcomings of our economy, they are more than made up by the right of anyone to work for whomever he pleases or to buy what he likes or employ his talents or wealth as he sees fit, within certain established rules. These freedoms surely merit preserving.

Taking all of these considerations into account, it is possible to attempt a general answer to the question posed at the beginning of the article. Productivity gains are a joint achievement in which all members of the community play some part. Although specific conditions vary from situation to situation, certain basic premises apply to all labor-management dealings: It is essential that the following major requirements be satisfied:

1. Obtain a reasonably high degree of cooperation and performance from those directly concerned.

2. Give due regard to the interests of the rest of the community so as to gain widespread support as being fair and equitable.

3. So carry out this process of decision making as to distribute the national income in a manner that will promote stable and adequate economic growth.

4. And, finally, give due weight to the fact that the production of goods and services is but a means to an end, to promote material conditions that will help provide conditions in which as many members of society as possible are offered the opportunity to realize their varied interests and respective potential.

The attempt to balance the demands of these goals to obtain an acceptable and suitable combination is not easy. Moreover, a call for economic restraint and justice may sound anachronistic in the rough and tumble world of labor and business affairs. But unless this is achieved, it is not likely that these goals will be forgotten for long. Rather, an aroused public may seek other, more acceptable solutions that will not be as tender to the interests of those groups that have proven intransigent.

WILL MORE SUCCESS KILL FREE ENTERPRISE?

Edward Wisnewsky*

An economic revolution took place in the United States beween 1935 and 1960. While the causes for this may be disputed and will provide materials for hours of disagreement, the fact remains unchanged and waits for its historian. Most adults over forty have lived through a period which can correctly, I think, be called a prosperity explosion or harvest depending on the point of view -- a period of mass consumption unparalleled in the world's economic history. The gap now existing between the well-being of the American citizen and that of the citizens of most of the rest of the world has probably never been as wide.

This economic revolution has some aspects of particular importance for those of us engaged in planning and directing manufacturing establishments. During this period, in the main, our economy has not been directed. Certainly the American attempts at such direction have at no time, except for the war years, been anything like the various controls in effect in other industrialized nations. As a result, "free enterprise" has a special American meaning.

Insofar as the majority of manufacturers are concerned, "free enterprise" can be taken to mean a state of affairs where the allocation of production efforts is arrived at by a means other than that of a designated regulatory body established as a part of the process of political government. It involves the notion of a market place which has definite characteristics: in fact, it is a notion that is meaningless without such a market place.

The most powerful argument against the imposition of controls in that market place is the gap between our well-being and the conditions of individuals in other nations. It is well, however, to keep in mind the argument that this course of reasoning rests on the assumption that, if left alone, the nature of the market place as we have known it will be retained.

It is tempting to believe that the future will continue along the lines of the past, and in particular that beliefs about the values to be applied as criteria and guide posts will continue to be useful. In the short run, this tendency may often be quite sound as a practical matter. Even a complex mathematical curve can be treated as a straight line if the interval considered is made small enough. Yet I, for one, think there

---

* Mr. Wisnewsky is Executive Vice President of the Gleason Corporation, Milwaukee, Wisconsin.

are signs that we are entering a new phase of economic history, one which will subject our assumptions based on one idea of the market place to a severe test, and which may cause manufacturers to frame new planning objectives.

In this discussion I intend to present observations drawn from personal experience in manufacturing which seem to point to such a conclusion. I have no desire to frame a theory, but only to point out that practices and existing theory are at points some distance apart. The presentation will center around the points summarized here:

> It is increasingly difficult for manufacturers to develop significantly new products, as differentiated from product changes or lower-cost substitutes for existing consumer items. This has two effects: (a) it makes marketing strength an important manufacturing objective and affects selection of products as well as their design for manufacturing; (b) it promotes mergers for the sake of product-line diversification and drives the economy to a state where the larger part of the productive capacity of the nation is under control of a few organizations.
>
> Despite the implication of the charges made by critics, advertising techniques have not been able to create any new consumer wants. The brain children of many inventors, although patented, have no market utility and no prospect of such utility. Product expansion in the market place has been mainly in the area of familiar wants and in the field of labor-saving devices. The average citizen in many instances seems more interested in what his tax money can buy for him than he is in maximizing his real income in terms of consumer products.
>
> The long-term trend toward satisfying consumers is to do so by means of smaller and smaller packages, by simpler functional design utilizing fewer materials and less manpower in their production. The added value is not sought in the product itself, but in convenience in its use -- not the result of something which can be patented but in the way it is packaged. In part this is due to mass distribution practices which have helped redefine the market place.

It is my thesis that these observations are not independent, and that when considered jointly they indicate that some ideas previously useful in guiding the formation of operational philosophy in business need changing. They need changing in order to promote the survival of existing enterprises. There are other consequences of importance here, but my personal experience limits my conclusions, except in summary, to this narrower field of operating practices.

The New Product Difficulty

The fact that it is very difficult to create a profitable new product or to provide a significantly new feature which is the result of invention or boldness of approach is evident in the market place. Business research expenses increased six-fold in the period 1945-1957, but the results by

any standard insofar as consumers are concerned are meager, indeed. This does not mean that nothing new was evolved, but it does indicate that today novelty or the creation of a new form for manufactured wealth is not enough to stimulate the processes which used to result from the presentation of a product new to the market place.

The fact that there is no scarcity of goods in the market place, then, limits the utility of a new idea. This is of profound significance and indicates that we need some new concepts about the nature of the market place. The emphasis on marketing research is in itself evidence that there is a great deal of ignorance about the nature of the modern market place, and ought to serve as an indicater that we might well be careful of conclusions drawn from older descriptions of that marketing arena.

There will be some to cheer the observation that it is very difficult to create a new product today. It is no secret that many have believed that the emphasis on producing new forms of manufactured wealth so characteristic of American society is wrong. A survey conducted recently indicates that businessmen have some serious doubts about "planned obsolescence" as a technique for keeping factories busy.[1] Now whether this is squeamishness due to remnants of older economic theories derived in part from a political and hence inevitably moral economic model, or whether it is the result of a suspicion that the process is not pragmatically adequate for its self-assumed task can be debated.

But it is one thing to see an end to the multiplication of products as the result of debate and decision, and still another if the insensible evolution of our industrial society takes us to this point because it becomes unprofitable to multiply products. Such an evolutionary current would not only be independent of our value judgments, but also irreversible.

Why is it likely that the change is evolutionary? The answer given necessarily anticipates a conclusion. I think it is in part because the reservoir of unfilled wants for items which can be fabricated on a mass production basis is growing smaller -- and there seems to be no way of expanding this reservoir other than by population growth. It is also due in part to the impact of the mass distribution system, which makes what is unprofitable for the mass merchandiser also unprofitable for the manufacturer oriented towards mass production. Some such belief already shapes manufacturing strategy, and I offer in evidence these observations:

> In manufacturing, we are entering a period in which the dominant objective is cost reduction in product fabrication.
>
> In manufacturing, we are in a period in which almost every long-range plan is directed toward the development and maintenance of

---

1. "Problems in Review: Planned Obsolescence," Harvard Business Review, September-October, 1959.

marketing leadership; from the plant standpoint, this means trying to make sure that orders will be available to justify operations.

Both of these orientations are the rational outcome of the desire to maximize profit potentials of existing product forms, because there is no way to escape by switching to another item more profitable in the market place. The stress on product modification initiated and maintained by marketing managers is to be understood in terms of efforts to maintain existing profit potentials for as long a time as possible in a situation where scarcity no longer creates opportunity. Mass consumption is here and it, rather than product scarcity, is the fact around which thinking must be built, as sales executives well know.

Let's look, in greater detail, at what this means for the manufacturing management:

Mass consumption, along with urbanization, has fostered the development of large scale retailing and particularly, now, the shopping centers. Buying traffic has not only been concentrated, it has been regionalized. The space in which products can be offered is restricted, and this fact cannot be ignored. The market place defined by the area in which the customer acts is actually quite small in geographic extent. There is a battle for the coveted display positions. This is certain to become more intensified as the technique of retail management becomes further advanced, and permits rapid expansion of display and selling areas in response to customer action with contraction of other areas less profitable in dollars per square foot per hour. For manufacturers it means that it is more important than ever to establish commercial relations with such mass retailers.

The relationships are being affected by the realization that importance as a supplier depends upon the total volume of business done with the customer. Obviously, if the manufacturer is successful in selling a variety of products his replacement in order books by a competitor with only one product is less likely. This observation, coupled with the difficulty of originating new products, gives the customer leverage over the one-product supplier. In the long run it tends to force that supplier into producing other items for the mass market, often at lower profit margins.

The only escape from such a fate is to broaden market strength by acquisition of other market suppliers or by mergers. This is an attempt to maximize market strength. Manufacturing strategy is being deeply influenced by this defensive procedure, which can be described as marketing through product packages. The result is that apparently only the larger enterprises aggressively oriented toward the market place can expect to survive and earn satisfactory profits.

A study of the ways in which mass distribution channels have affected manufacturing practices and strategies is badly needed to clarify our understanding of our present economic structure. It seems to me that the effect has been considerable and that it promises to have a greater impact in the future. Harold F. Smiddy, Vice President for

Management Consultation Services of the General Electric Company, in an address reprinted in the July 1959 Advanced Management, points out that the distribution system of our nation is ripe for the coming of a Frederick Taylor.[2] Mr. Smiddy makes the observation that "Product was not really the basis around which the systematic orderly approach in the factory was built, but rather it was built around the work process itself." The question naturally arises, what would happen to retailing, and therefore to the market place, if concept patterns organized around the analogous "work process" came into operation? Would this not necessarily affect manufacturing objectives? The self-service store points a way here.

The drive for cost reduction through product and process change is in part a response to the impact of mass distribution. Cost reduction emphasis has led us to take out some of the safety margins originally put into the product, and this in turn has defined "quality control" so that it means, "what kind of process results must we have in order to get the most mileage out of this lower cost material or process?"

To understand why manufacturers have been driven into this position we need additional clues to be gained from a look at the remaining theoretical potentials for product exploitation.

The Last of the Old Frontiers

The last open area for rational exploitation through traditional patterns of marketing philosophy appears to be the personal service field. A quick look at additions to the list of consumer products of recent years indicates that a considerable number have a "personal service" character. Units such as massage tables and chairs, exercising machines, vibrators, and the like, provide substitutes for quite personal service. Do-it-yourself and labor-saving devices for the modern housewife and her husband have the same general service nature.

Along with this, of course, we can see the exploitation of push-button devices to extend the individual's power. Weather control through air conditioning has been attained. It can be expected that more built-in push-button devices, permitting men to extend their powers by the use of a methodology reduced to mechanism, will appear.

The creative areas have been opened to such exploitation with art kits making possible accomplishment by the use of coded procedures, and quite complicated electronic devices can be put together by the same sort of instruction codes. Much more could be done here. In a more significant way, development of drugs may provide means of managing the psychological environment on a made-to-wish basis.

Yet, to mention these items, foreseen years ago by Aldous Huxley

---

2. "Opportunities for New Contributions to the Future of Management by SAM Members," Vol. XXIV, No. 7, p. 5.

in his novel The Brave New World, is to focus attention on the fact that product expansion in the consumer field has been in the area of age-old wants and ego satisfaction, and that the prospect for future development is in the same inherently limited area. The reasons that people buy today owe more to Freud's explanations of behavior than they do to the notions embodied in the economics of Adam Smith. In this we may have a clue to the picture of the market place which we might find profitable.

If the empirical evidence from manufacturing is to be relied upon, there is a boundary to the diversity of products which mankind will buy. But we need not rely on just a businessman's observations. In a recent article, W. W. Rostow, Professor of Economic History at the Massachusetts Institute of Technology points out that in the last ten years Americans apparently are placing a lower valuation on improving their personal material well being than they are on the advantages and values of enlarged families.[3] And this consumer vote is a value-judgment not to be disregarded.

There is, thus, some evidence that little has really been done in expanding the scope of human wants and that there is a limit to the uses of material items for the satisfaction of such wants. Now it may be that adventures into outer space will bring some change here; but the present situation is nonetheless surprising if popular notions about the effect of advertising are correct. These notions are a part of our operating philosophy in business. Are they, therefore, wrong?

The Role of Advertising

A recent writer on advertising makes the statement, "The advertising industry seems to be built on a foundation of sand."[4] It is my contention that those who criticize advertising for its social effects have an equally sound foundation.

Professor David M. Potter of Yale, in his book, People of Plenty, claims that advertisers "understand that advertising operates more to create wants in the minds of people than to capitalize on wants that are already active."[5] There is nothing new in this charge, including the fact that it is not so.

On the very next page Professor Potter says, "In a situation of limited supply the scarcity of his product will assure his place in the market, but in a situation of indefinitely expandable supply his brand is his only means of assuring himself of such a place." The two statements

---

3. "Economics for the Nuclear Age," Harvard Business Review, January-February, 1960.

4. Jay W. Forrester, "Advertising: A Problem in Industrial Dynamics," Harvard Business Review, March-April, 1959

5. University of Chicago Press, 1954, p. 172.

are incompatible except in a trivial sense, and the last statement, although it is over-simplified, contains a valuable insight.

A more valuable contribution to the understanding of advertising is made by two recent articles in the Harvard Business Review, the article by Jay W. Forrester referred to above, and "Marketing - A Lesson for Marx" by Marshall I. Goldman, who discusses changes in the Russian economy which are creating a role for advertising.[6]

As an alternative to Professor Potter's explanation I would say that if advertising does anything at all, it re-enforces the desire to satisfy existing wants, provided that we are sufficiently sophisticated to include Freud's notions of the nature of the human being along with the notions of economic man. It not only does this, but it also identifies the sources available for such satisfaction and protects existing relationships beween the manufacturer and the mass buyer or retailer. It is this last which gives advertising its manufacturing significance. This is indeed a considerable accomplishment. There is no need to credit advertising methods with more.

The use of statistics to support a conclusion must always be tempered with caution, and never more so than in drawing conclusions from the amount of money spent by advertisers. The important thing about the total spent is determining who accounts for the bulk of such spending. The big funds are being spent on a relatively few products. From such an analysis we can hope to discover the different functions of advertising.

The moralist's real ground for being critical of modern advertising is not because of creation of wants, but because of the practices used in the fervent effort to preserve or enlarge for commercial exploitation what might well be morally or esthetically indefensible desires. Even this might not be as important as the use of certain symbols as attention getters.

This is not to say that no effort has been made to enlarge the area of commercially satisfiable wants, but it is to question seriously the success of such efforts. Marketing failures cannot be ignored in the evaluation of the intrinsic nature of advertising.

In spite of programs utilizing even more potent means the record shows that a greater percentage of our income is being spent in directions which have not been pre-selected by advertising and selling efforts. This is evident in the studies of expenditures in the middle and higher income level groups. And with regard to many items, it is debatable whether sales volume is influenced more strongly by advertising appeals than it is by straight price reductions. All of these considerations indicate that a more intensive study of the composition of advertising expenditures and

- - - - -

6. Harvard Business Review, January-February, 1960.

the theoretical assumptions involved in the advertising philosophy is required.

From the standpoint of planning industrial strategy, advertising techniques can tell us what men may reasonably be expected to buy and how to gain the maximum volume out of a given buying public. This, however, only confirms the conclusion that our past industrial development depended on the existence of a sort of unexploited economic frontier of unfilled desires which has now largely been closed off, a frontier made up of wants traceable to the structure of the human animal and of a given cultural form. It would be well to determine if some of the early advertising success was founded on the susceptibility of a population which had recently learned to read and had a naive attitude towards what was published.

If industrial development of the past was conditioned by such a frontier, then the prosperity explosion must be regarded as a temporary phenomenon, playing the same role in economic history as did the frontier in our political history. There is one other piece of empirical evidence which affirms this diagnosis. At the present time in our economy, it is quite obvious that many persons have access both to the capital and other resources required to take advantage of a manufacturing opportunity. What is missing, in classical terms, is a profitable and therefore a socially important opportunity -- an opportunity we call a market potential -- something which can be converted into dollar figures on a cash flow projection sheet.

This is not to say that the opportunity to compete has vanished, but rather that essentially more and more such opportunity is limited to price competition. The experience of many small manufacturing enterprises provides ample testimony of this.

The conclusion seems unavoidable: we cannot continue to build policies around the notion that our economic system is to be understood solely in terms of a social mechanism whose prime function is to reduce poverty and misery due to shortages of goods. It should be remembered that the usual untested assumptions involved in setting organizational goals necessarily stem from such a notion. It is only when we subject our policies to scrutiny that we find a need for a new set of assumptions.

Ironically enough, the shortcomings of the previously useful assumptions may be due to the real success of the system of social mechanisms created around these assumptions in the past. Today however, we must regard our business entities as machines designed to do one job and to be ruthlessly rebuilt or scrapped when one entity shows better machine-like characteristics than another. When we use dimensions in evaluating performance we are inevitably talking about machine-like traits.

What, then, can we reasonably expect in the way of future developments in manufacturing, using only empirical observations for such a projection?

The Manufacturing Future

There are three recent trends which can be expected to exert a powerful effect on at least the short-range manufacturing outlook:

1. There is the trend resulting in the concentration of economic power, that is, more of the consumer goods are being made by fewer organizations.

2. There is the trend toward satisfying economic needs of consumers by finding ways of fabricating lower-cost substitutes for the packages presently sold. In a real sense, what we are trying to do is find the modern equivalent of the philosopher's stone by which cheaper material can be transformed into the functional equivalent of a higher priced material.

3. There is the trend to concentrate on efficient performance, that is, to narrow the range of the yardsticks used in measuring the worth of all internal activity of the organization. What we want is a "profit-effect" yardstick applicable to every act.

These tendencies lead to one result, a reduction in employment per unit of output. We can hide this by using the term, "gain in productivity per manhour."

The first of these tendencies is amply discussed in the economic literature of our day, the other two points must draw increased attention. Unfortunately, they are not as easy to see as the first trend. One has to be a participant in manufacturing for some time to discern them.

The general objective of product development today is to create a design which reduces material requirements and labor needs without impairment of the function expected by the customer. Product design often is design where probabilities of malfunction are calculated with considerable precision and safety factors are reduced to a minimum. As a result, product engineers often require retraining before they can carry out their functions properly, since the engineering schools have missed this point. In manufacturing today the greatest economic rewards are won through successful development of substitute materials and components which facilitate the kind of redesign permitting cheaper manufacturing costs.

While the product designer is occupied with the task of making smaller units do the job of larger units, the purchasing agent enrolled under the banner of "Value Analysis" makes his contribution to the modern industrial order by seeking to stimulate the adoption of lower cost components and their further development on the same basis of functional equivalence in the market place. The pressure on the supplier here adds to the resources of the internal organization driving in this same direction.

From this has come the wider use of plastics, the use of single parts to perform multiple functions, the simplification of design so as

to use standardized elements already produced in volume and near-fabulous cost reductions with a great appeal to mass distributors. It is quite likely, therefore, that future products will differ most significantly from those of the present primarily because of cheaper means to get the same result. The expansion of the population will, in itself, accelerate the process simply because the volume increase will make success more rewarding.

The growth of population will produce improvement in the productivity index simply because it makes straight-line production economical where job-lot production is now customary. Thus, it seems clear that we do not need more persons in production, but that we are going to find it difficult to keep as many persons working on production as we now have. The possibility of absorbing the technologically unemployed in new fields of manufacturing activity appears to be sharply reduced -- even their identification is made difficult when redesign of products is responsible for reduction in manpower needs.

Does this mean that nothing can be expected, or can be done, to boost manpower needs in a product? And by this I do not mean feather-bedding labor practices, but rather action in the market place. It seems as if something could be done here, but that such efforts have to result in altering customer demands in favor of values which cannot be supplied by lower cost substitutes. There is no doubt that the over-size car trend operated to hold higher employment levels, as might also be expected if consumers demanded larger houses, bigger appliances.

The much maligned product obsolescence policy in merchandising strategy has contributed, I believe, at least these two things: (1) it has stimulated the excess of optimism required to build manufacturing capacity to a level at which surplus capacity exists, and (2) it has concealed the fact that this nation may in general have been operating with a considerable number of obsolete economic doctrines. A rational program which seeks both to eliminate product obsolescence and preserve natural resources, and also to stabilize employment levels without approval of monopoly or cartel arrangements, is at present unimaginable. All the morality-based arguments in the matter point to no means by which such goals are to be realized.

What is most apparent today is that the basic business strategies now used in industry are primarily defensive in character. This is evident in many ways. In manufacturing we are engaged in protecting investments in the only rational way possible under existing circumstances. This may indeed be the significant fact, that the current situation has been created by measures which are rational, even though generally misunderstood.[7]

---

7. For a more intensive treatment see the author's article, "Manufacturing in Jeopardy," Harvard Business Review, November-December, 1959.

An Interpretation

What does all this mean? It means, first of all, that manufacturing practices, insofar as they are realistic and reflect the state of today's market place cannot be understood in terms of the rationale appropriate to a market condition of scarcity. It means that in manufacturing today we stand in need of a rationale -- an economic philosophy if you will -- in which our practices make good sense. This rationale must provide us with a language which redefines opportunity, must face the fact that the market place has changed in a fundamental way. We need new concepts so that objectives can be easily communicated and made easier for all participants in manufacturing to understand.

Such a rationale would necessarily alter the framework in which we conceive of supplier-customer relationships and, inevitably, the frame of reference used in thinking about labor-management relationships. But I think the most vital result would come in the ideas we would use in setting standards of both executive and subordinate performance. These are just a few of the thought-areas now largely dealt with in terms of the market place of "free enterprise," if not in our practices, at least in our arguments with each other.

But there is still another aspect of the problem to be considered. The relationship between the political orientation of the manufacturer and that of the public has been determined by notions as to the nature of the economic system. The manufacturer may need to re-examine his political orientation. The public will need to alter its notions of what the role of the manufacturer must be in this new market place. Competition needs redefinition and with it our public policy towards competition. Traditionally the manufacturer was looked upon as the source of new products, of new wares eagerly waited for by a public ready to trade. The historic attitude has been to encourage manufacturing for this social purpose. But, if I am correct, today's market place has a new role for the manufacturer and the social value and social importance of this new role remain to be defined.

While it is true that some conditions of market scarcity exist, it is also true that this is not due to a shortage of manufacturing capacity as such. All of these factors indicate that "free enterprise" as we have customarily regarded it will be altered in the future. To this observer this is the result of the real success of our "free enterprise" system in meeting its historic goals.

HOW CAN MANAGEMENT DEVELOP A SOUND INSURANCE PROGRAM?

Howard C. Launstein*

Today there is an increased awareness by top management of their firm's need for a sound insurance program. In the past, management unfortunately did not recognize the effect of a sound insurance program on the operating costs and asset maintenance of the firm. Administrators were in many cases persons who had no specialized knowledge of insurance.

Today more companies recognize this need and are employing trained personnel as insurance managers. An insurance manager performs the same function as a buyer in any other part of the firm, for example, a purchaser of raw materials. He renders an informed judgment on the various insurance coverages available. Although all firms can not afford this staff position, it is possible to secure this service from independent insurance consultants. Whether the company secures this service from outside or from a member of its own staff, proper protection can be had by the application of fundamental principles of insurance buying. These principles include consideration of the need for protection, the extent of possible losses, the probability of loss, methods of reducing insurance costs, and the contents of the insured's present policies and the coverages they afford. He must also consider other methods of risk management. An underlying principle in risk management is to determine the most economical method of risk handling after due consideration of all factors.

Determination of Protection Requirements

The first principle is to determine where the need for protection exists. Most people recognize the existence of such perils as fire, windstorms, and so forth, but less consideration is given to the consequential losses (indirect losses) resulting from the destruction of property or life by these perils. These indirect losses may be increased operating costs, loss of profits and commissions, terminated leases, destroyed records, and so on. Any or all of these would cause serious financial loss to the firm and protection against them is as essential as protection against the direct loss of a building by fire. If the funds are not available to cover all such perils, the insurance manager or advisor should determine which contingencies would cause the greatest financial loss to the firm and cover these contingent losses first.

---

* Dr. Launstein is Associate Professor of Finance and Director of the Department of Finance, Marquette University.

Coverages Required by Law or Contract: Certain coverages are required by law or contract. Some of these are (1) workmen's compensation; (2) bid bonds on government or private contracts; (3) pension, group life, and group disability insurance plans required by many union contracts; and (4) the quasi-compulsory coverage made necessary because of the Financial and Safety-Responsibility Laws.

Other coverages are necessary to the firm because of the financial loss which would be suffered through the destruction of life or property. Life insurance on key employees should be large enough to cover any loss suffered because of interruption in business affairs by death of said employee. In many cases someone must be trained for the position or hired from outside the firm at perhaps a higher salary. In either case, a transition period is necessary. In the case of a partnership, sufficient insurance should be carried on the respective partners so as to permit those remaining to purchase the interest held by the deceased. This arrangement should be provided for by the inclusion of a buy and sell agreement in the articles of partnership. Otherwise, the business might be forced into liquidation with a sacrifice of asset values because of forced sale or the acceptance of the deceased's heirs as partners.

Firms are also responsible for third-party liability. Some of the questions that require answers in determining the extent of coverage are:

1. To what extent are the firm's operations subject to large losses because of bodily injury or property damage?

2. To what extent can the firm afford to suffer large losses?

3. What is the prevailing trend of juries in awarding large judgments?

4. What additional coverage is necessary to cover liabilities in excess of statutory limits?

Some examples of the importance of these answers can be found in the following judgments awarded by the courts. An Ohio cab driver was awarded $150,000 when his wife lost her sanity because of an automobile accident. In another case, a judgment for $100,000 was awarded when an "I" beam protruding from a steel company truck swept some radar parts from a passing railroad flatcar. Most of you are familiar with the fact that high awards are being made in and around Chicago. You may remember reading about the case in Chicago where a child was awarded a judgment of $750,000 against a gas company and an electric light company. The case was finally settled for $600,000 cash. You may also remember the case of Lawrence M. Rohde versus the Olsen Transportation Company of Green Bay in which an award of approximately $117,000 was granted. This case was in Milwaukee. All of these examples show that it is necessary for an insurance manager to determine what the upper limits of liability may be for his firm.

Adequacy of Coverage: The adequacy of the present insurance program can best be brought out by an "insurance survey" or "risk analysis." A complete insurance survey should:

1. Determine the property, perils, and losses to which the insured is exposed.

2. Determine the best and least costly way to arrange the insurance necessary to protect against these exposures.

3. Study loss prevention in order to utilize all avenues for rate reduction.

4. Analyse the present insurance and make the necessary changes to adjust the insurance to the recommended program, and

5. Provide a method for keeping the insurance program up-to-date.

Extent of Possible Losses

The second principle is to determine the extent of possible losses, and buy coverages for the major uncertain losses only. Many people tend to swap dollars for dollars in the sense that they buy coverages, such as emergency road service, where only small losses are involved. Yet they tend to leave potential large losses uninsured. Another example would be a wealthy man's buying a hospitalization policy instead of a major medical policy with a large deductible clause. Most people can withstand small losses. It is the large ones that cause financial hardships and should be covered.

In covering large catastrophic losses, the insured must be reconciled to the fact that he may pay premiums for years without any recovery. An example of this would be the disability income rider attached to a life insurance contract. There is a six months' waiting period before disability payments are made. Most disability cases cease before the end of six months. In the few cases that do continue, the income provided could be of great financial assistance to the insured.

Many people consider such losses unlikely to happen to them, and are seldom covered. They prefer to spend their premium dollars to insure potential losses where they are more certain to receive at least a portion of their premium dollars in loss payments. This is not sound insurance programming. It is the large unforeseen loss that causes the greatest financial burden, and this is the loss that should be insured. The other is desirable only if premium dollars are available.

The insurance manager should consider the possibility of his firm's becoming a self-insurer. He should also consider the use of large deductibles. Where a firm is able to suffer a loss without harm to the financial status of the business itself, such plans are feasible. For example, the Standard Oil Company of Indiana has carried a $500,000 deductible fire insurance policy on its properties. Each firm must determine the amount of risk that it is financially expedient to bear. The amount may vary from year to year and from firm to firm.

Analyse the Probability of Loss

The third principle is to analyse the probability of loss. "The cost of insurance is in part a function of the percentage of insured property which will be destroyed by the insured peril in a given time period."[1] The insurer collects from each insured his proportionate share of the losses for the group plus a loading charge for the estimated operating expenses and underwriting profits of the insurance company.

The probability of loss ranges from zero (no chance of loss) to unity (certainty of loss in a given period). It is usually expressed in a fraction. If a certain area of land could be expected to flood every other year, the fraction would be 1 to 2, or 50%. High probability of loss makes insurance premiums very expensive, especially when the necessary loading for operating expenses is added to the basic premium. There are cost and protection limits which establish the range extremes where it is economically feasible to buy risk coverages required. The upper limits beyond which the buyer is unwilling to buy insurance is impossible to determine with exactness. It is determined somewhat by the firm's financial status and its willingness to take a chance. The lower limit would be the point where the buyer considers the likelihood of loss to be so slight that he is willing to assume the burden himself. The extent of the loss to be suffered will cause this lower limit to fluctuate; for example, a potential claim for $100,000 would outweigh a small probability of loss. The relative amount and the probability of loss must both be taken into account in determining the amount of insurance protection needed.

Ways of Reducing Insurance Premiums

The fourth principle is to determine methods by which insurance costs may be reduced. Some methods now in use are:

1. Deductible insurance which has been developed to eliminate coverage on small losses. Small losses tend to occur fairly frequently. The use of a high deductible is less related to loss frequency. It has been designed to give the insured the opportunity to assume any loss up to the limit that the insurance manager feels his firm is able to absorb. The savings in premium between a $25 deductible collision policy and a $50 deductible one is almost equivalent to the value of the additional protection offered the insured. Thus, the larger deductible policy tends to lower insurance costs.
2. Coinsurance which offers the insured a reduced rate per unit of protection in return for the firm's acceptance of a volume of insurance based on a stated percentage of the property value. If the insured does not carry the required amount of insurance, the firm becomes a coinsurer with the insurance company on all losses. If it does carry the required amount, it has 100% protection on all losses up to the face of the policy.
3. Contracts with terms of more than one year, such as three to five year contracts. An example is the three-year fire

---

1. Excerpt from page 7 of a speech by John S. Bickley entitled, "Guides to a Sound Insurance Policy."

policy which has a premium cost of approximately 2-1/2 times the premium of a one-year policy.

4. Compliance with certain construction and operation standards as set forth in the local building codes and underwriting rating classifications. Some of the requirements found in the building codes and rating classifications include construction standards, installation of sprinkler systems, fire doors, fireproof containers and fire alarm systems, watchmen, etc.

5. Selection of insurers who offer low rates and quality service. This is made possible by careful risk selection, economical distribution and efficient administration by insurers.

6. The inclusion of a self-insurance plan. This is possible where an adequate fund is administered in a proper manner separate and distinct from the rest of the business. Other fundamental self-insurance principles include a large number of homogeneous exposures which are exposed to the same hazards and the individual losses are relatively small in value as compared with the whole. These exposure units should be widely disbursed. They should have a definite loss pattern. The experience of individual firms considering self-insurance should be favorable prior to the induction of the plan. Self-insurance should not be attempted by a firm in financial difficulty. Management must be willing to perform all of the services received from or required of an insurance carrier for a self-insurance program to be successful. These services include loss prevention, claim services, maintenance of adequate reserves, periodic inspection and maintenance, and so forth. The insurance manager must carefuliy weigh the advantages, requirements and pitfalls of a self-insurance program before committing the firm to this method of risk-bearing.

7. Modified self-insurance or stop-loss insurance plan. This is where an insured agrees to suffer his own losses up to an amount equal to a certain percentage of its customary insurance coverage. An insurer agrees to assume all losses over and above the percentage or amount assumed by the insured. This device is especially appropriate for firms showing a favorable loss experience.

8. The use of group buying procedures. All firms with similar rating classifications in a given line of business place their total insurance needs for certain coverages with a broker. The broker presents the group's needs to an insurer who in turn provides the coverage at a reduced rate as is common in group life, hospitalization and pension plans. This makes it possible for a small firm to offer a greater variety of benefits to its employees and cover its other insurance needs at a premium cost more nearly competitive to that cost borne by a large firm.

"The economical purchase of insurance depends first on a proper

determination of the most important needs for coverage, second on the selection of the proper carrier to handle the risk, third on the writing of the insurance on a basis which best serves the interest of the buyer, and finally on a consideration of all possible alternatives to the use of insurance."[2]

Familiarization with the Firm's Insurance Policies

The insurance manager should endeavor to acquaint himself with the coverages afforded by the present insurance policies. Although courts tend to construe passages, the meaning of which is not clear, in favor of the insured, ignorance will not alter the coverage of the contract.

All insurance contracts contain five major divisions or areas of information. They are the declarations, insuring agreements, exclusions, conditions, and endorsements.

Declarations: Declarations include such things as the insured's name, location, and description of the property, and any other specific facts required for underwriting, as well as the amount of insurance requested, the premium for each coverage, and the term of the contract. The insured is held responsible for all material facts in these declarations. A material fact is anything which would cause the insurer to refuse to issue the policy or to have it issued at an increased rate. An example of this would be a truck that hauls combustible materials being insured as a produce truck. Such a misstatement of fact would relieve the insurer from liability. In addition to this, the insured must reveal pertinent information which might influence the underwriter's judgment, even though no inquiry was made concerning it.

Insuring Agreements: Insuring agreements state the perils insured against and the obligations that the insurer will assume. The obligations of the insurer include such things as inspection of the premises, defense of the insured when legal action occurs, payment of any immediate medical expenses and the investigation of claims. In the case of boiler insurance, inspection costs account for a major portion of the premium.

Exclusions: Exclusions are divided into five categories. The first of these are objects subject to excessive hazards. The example of such hazards is the use of automobiles as public or livery conveyances when insured as private vehicles. Another example is the use of a house as a dry-cleaning establishment when it is insured as a private residence.

The second category is catastrophic losses. This refers to the unusual losses resulting from such occurrences as war, including invasion, civil war, insurrection, rebellion and revolution.

The third category of exclusions eliminates coverage on property normally covered under another insurance policy. For example, automobile liability policies exclude losses covered under workmen's compensation

---

2. Ibid., pp. 12-13.

insurance. Business activities which are covered under the comprehensive general liability policy are excluded from the personal comprehensive liability policy. The mercantile open-stock burglary policy does not apply to losses normally covered under one of the fidelity policies, for example, fraud or embezzlement by employees.

The fourth type of exclusion is for losses wholly or partially under the control of the insured. These include losses caused by or at the direction of the insured such as the insured's automobile or truck running into and damaging his own property. It is contrary to public policy to allow the insured to recover for such felonious self-destruction of his own property.

The last of these exclusions covers loss to property due to normal wear and tear. Insurance is designed to protect the insured from accidents and not from the gradual deterioration of property. Depreciation is a normal business expense and should be recovered from revenues over the life of the asset.

Conditions: The fourth major division of the policy states the conditions affecting the contract. They include the definition of the terms used in the contract and a statement of the rights and obligations of all parties. For example, in the fire contract, fire losses are those resulting from a hostile fire outside of its proper confines. Hence, smoke damage caused by faulty operation of the firm's heating plant is not recoverable. Burglary coverages become effective only when there are visible marks of entry into the premises after business hours. Losses during business hours in which an employee is placed in fear of physical injury would have to be covered by robbery insurance. It is important for the insurance manager to know the technical meaning of the various terms used in the contracts so that he may ascertain whether the proper insurance coverages are being secured according to the firm's needs.

Limitations on the insured's recovery include (1) the limits for the individual as well as the total limits under the policy; (2) the restriction of loss payments to the actual cash value of the object destroyed; (3) the adherence to coinsurance, pro-rata distribution clauses, or other requirements such as other insurance on the property; (4) the prohibition of the abandonment of property to the insurer; (5) the provision for the replacement of property by the insurer rather than cash indemnification for the loss; and (6) the conditions relating to salvage.

Other conditions set forth in the contract are the duties of the insured in case of loss, the requirement of notice and proof of loss, the assistance that the insured must give, the subrogation of the insured's rights, the conditions as to cancellation or suspension of coverage, the inspection of property, assignment of the contract, insolvency or bankruptcy of the insured, rights of the agent to change the terms of the contract, and the effect on the policy of declarations made by the policyholder.

Endorsements or Riders: The final portion of a contract contains the endorsements or riders to the contract. These endorsements or

riders extend or restrict the coverage of the basic policy, correct errors in the contract, state assignments of interest in the contract, transfer coverage from one object or location to another and state any changes in the amount of the coverages in force. The endorsement takes precedence over the section of the basic contract that it modifies and lends flexibility to the insurance contract so that it will meet the needs of various insureds.

Examine Other Methods of Risk-Bearing

Insurance is only one method of risk-bearing. Other methods that may be employed are the control of risks through educational means, the transfer of the risk to specialists, the assumption of the risk by the insured, and the combination of groups or firms formed to offset individual uncertainty of loss by pooling their risks so that the firms suffering losses will not have to bear all of their own individual loss. The losses will be spread among the group participating in the plan. The latter is one method which the insurance manager might use to cover hard-to-place business.

The most desirable solution to risk-bearing is the elimination of risk in its entirety. This is impossible unless the firm disposes of the object exposed to the risk. The next best solution is the prevention of losses through research which reduces the causes of the loss. An example of this would be the proper placement of guards on machines to prevent injury to workers. Other examples would be the use of non-skid surfaces in such places as stairways and halls and the adoption of certain safety practices in the handling of combustible substances. The introduction of these safety measures will lessen the severity and frequency of losses. It will pay dividends in terms of fewer man-hours lost, increased production and lower insurance or other risk-bearing costs.

The insurance manager should explore the possibility of transferring certain risks to specialists if it is not already being done. The use of hedging practices by grain dealers, sub-contracting by primary contractors and the use of bid bonds in large contracts are examples of this practice. It tends to relieve management of some of the risk which normally places extra burdens on the finances of the firm. Under insurance, risk is not transferred entirely, as each insured bears a known portion of it, namely the insurance premium.

If losses are limited and predictable, management can safely assume the risk by the creation of a reserve fund which is subject to the same rules as self-insurance. A small company would be ill advised to cover the risk of liability judgments in this manner. The assumption of risk without a fund, unless the risk is very small, would be like an individual's meeting the event of premature death before the funds have been saved to protect his family. There is definitely inadequate protection.

The combination of risks may take several forms. One example might be a small group of firms who are faced with a given risk which they are unable to cover or the cost if covered would be prohibitive.

Risks which were unacceptable for coverage might be accepted if the group was willing to carry a large deductible. Risks which were subject to prohibitive premiums might be underwritten with a substantial deductible clause at a reasonable rate. What might be a large loss to an individual firm would not be financially burdensome to the group. What the group could not handle financially without a serious financial burden being placed on its members should be covered, if possible. This practice is similar to what insurance carriers do when they pool their individual excess potential losses under reinsurance agreements. The result is a reduction of the burden that any one firm has to sustain because loss occurs.

Another form might be the incorporation of a number of firms into one for the purpose of increasing the financial ability of the group to withstand loss. Vertical and horizontal integration make possible a greater degree of stability of earnings by the exercise of control over supply and demand factors. Although a firm has control over its supply and demand factors, it may be seriously injured financially if, for instance, a key plant is destroyed. It may not have outside sources of supply for its other plants. The insurance manager must recognize this limitation. Otherwise, what appears to be a solution to a firm's problem does not actually meet the firm's needs.

Summary

The recommendations which have been proposed as the controlling factors in insurance buying may be applied to any business entity. When insurance is the proper solution to the problem of risk management, the contract should be adjusted to the needs of the insured as well as providing the lowest cost protection consistent with safety and service. Proper insurance purchasing considers each case separately in determining whether a given line of insurance is essential, required by law, desirable or simply available. What may be in one classification this year may logically fall into another classification next year. Therefore, the insurance manager must take an active interest in the firm's risk problems in order to assure consistency in obtaining the best coverage according to the firm's needs. This is accomplished by a frequent review of the present insurance carried. The manager must be sure that the necessary insurance coverages are obtained so that losses due to risks which are insurable will not cause serious financial strain to the firm. Good risk management assumes that the firm will bear that amount of loss that it can afford to sustain.

An adherence to the broad principles of insurance buying and a thorough analysis of the details of coverages required provide the ingredients of a "sound insurance program."

THE LITERATURE OF BUSINESS

Field of Management

REVIEWS

Wage Administration, by Charles W. Brennan, Richard Irwin Publishing Company, 1959, 439 pages -- Herbert G. Zollitsch, Associate Professor.

Mr. Charles W. Brennan is an Assistant Professor of Industrial Engineering at Lehigh University. He has indicated that his book contains plans, practices, and principles of wage administration for beginning students of wage administration. The book is divided into seven major parts and covers: (1) Introduction to Wage Administration; (2) Determination of Relative Worth of Jobs; (3) Determination of the Going Wage; (4) Wages and Wage Incentive; (5) Employee Evaluation; (6) Control of the Wage Administration Program; and (7) Exercises in Wage Administration. On the assumption that this book has been written for college juniors and seniors and for a one-semester course in wage and salary administration, the following is an appraisal in the light of these beliefs.

As an over-all evaluation, it is one of the better books to date which have come to the attention of the reviewer in an area which is conspicuous by its lack of books. Although there are numerous books in print on the many phases of wage and salary administration, the greatest majority of them only treat one area of the total picture. Brennan appears to have made the difficult attempt to include all of the phases.

The book has many strengths. The philosophy of wages is interwoven early into the subject matter so that the student is soon made aware that wage determination should be based chiefly on principles rather than on techniques. His writing gives the impression that he has had some recent practical experiences in the field. In the relative shortness of the book, as textbooks go, the author has covered a great deal of subject matter and has generally done so in a clear and understandable manner. The mature layman should not have any difficulty in comprehending the subject matter. Brennan's logical organizational and systematic treatment of the subject matter within each chapter are to be commended. In the last chapter, which consists of exercises in wage administration, there are several very good assignments.

The book appears to have some weaknesses. Although the subject of wage incentives is well treated, there is little or no attempt to interrelate the important part motion and time study plays in the determination of wages. The assumption may have been made that the student learns this in another course. The transfer of such learning, however, appears very slim unless the instructor in the other course is very well versed in wages and emphasizes the importance of motion and time study in setting wage incentive standards. It would appear best to do this in a book dealing with wages and salaries.

Another shortcoming is that only a token attempt is made to show a frame of reference as to where and how the function of wage and salary administration fits, or should fit into the organizational structure of an enterprise. Without this information, many of the principles and practices of wage administration become less meaningful to the student.

An obvious oversight in the book rests with the rather large number of illustrations which have no titles or identifying data as to what they are, or are supposed to show. Even if the beginning student could be forced to study the illustrations, there would be no assurance that the students would get the message intended by the author.

Some instructors might be handicapped by the absense of discussion questions for each chapter, which are usually found after every chapter in basic textbooks. Such questions are instrumental in stimulating student thought and in bringing out ideas, concepts, and principles. Brennan does have some thirty questions for chapter three and ten, general ones which seem to be a sampling of some twenty-five chapters. These may not be enough.

In short, it may be said that, in spite of the enumerated weaknesses, the book is one of the better ones in this field which, up to now, have come to the attention of the reviewer.

Management in Industry, by Claude S. George, Jr., Prentice-Hall, Inc., 1959, 570 pages -- Joseph G. Atwood, Assistant Professor.

Professor Claude George, Jr., the author of Management in Industry, emphasizes the manager: his function, the problems he faces pertaining to industry, and the techniques for solving them. To do this, management is described as an aid to decision-making. Along with this phase is woven the story of what the industrial management development has been.

After defining industry and management organization -- the subjects of product, factory planning, machines and equipment, employee relations -- work and wages are discussed. This explanation comprises most of the book. This phase of management points to the necessity of organizing and establishing good techniques to solve management problems.

The last phase of the management approach is control. The author considers that industry needs control and possible consequent corrective action. Management's objectives are summed up as responsibilities. Although ideas about business attitudes and responsibilities change, they change slowly. Today, however, modern enlightened management is developing an awareness and a philosophy of its multiple obligations.

The author satisfies the trend of writers today by presenting a less voluminous book and offers a clear and concise presentation of industrial management. To help clarify points in the chapter, case problems are used which are actual facts. Professor Claude George, Jr. has clearly written a logically organized book to show the true role of management in today's industrial world.

Personnel Management, by Herbert Chruden and Arthur Sherman, South Western Publishing Company, 1959, 670 pages --John P. Malloy, Associate Professor.

Dr. Chruden is presently Associate Professor in Business Administration at Sacramento State College. His experience includes time spent as administrative and personnel officer in the Navy during World War II. Dr. Sherman is likewise a member of the Sacramento State College, where he serves as Associate Professor of Psychology. His experience also includes time spent in the military as a personnel classification specialist.

A review of the topics covered, their treatment, combined with the brief description of the authors' background leads the reviewer to believe that both men are well grounded and expert in the areas of manpower selection, human relations, communications and industrial education. At the same time, this writer suspects that the authors lack first-hand experience in depth in several important facets of industrial relations. These include labor relations, contract negotiations, and wage incentives. The book suffers in this respect, although this criticism does not mean that this weakness is incapacitating.

The organization of materials, the printed format, and the use of illustrations are excellent. The references supplied at the end of each chapter will be most helpful to the instructor and the inquiring student.

This text will make excellent supplementary reading. It might well be used as the basic text in the beginning course in personnel administration provided the instructor takes steps to compensate for the deficient cited areas.

The impact of the research from the disciplines of anthropology, psychology and sociology is fast demanding that the capable leader, and particularly the personnel administrator, orient his thinking so that he is sufficiently aware of the dynamics of human behavior. This new text in personnel management reflects the growing influence of the social and behavior sciences in the world of work.

BIBLIOGRAPHY

1. Personnel Function by American Management Association, New York, 1959.

2. Problems and Practices in Industrial Relations by American Management Association, New York, 1958.

3. Motion and Time Study by Ralph M. Barnes, 4th ed., Homewood, Illinois, Richard D. Irwin, 1958.

4. The Practice of Collective Bargaining by Edwin F. Beal and Edward D. Wickersham, Homewood, Illinois: Richard D. Irwin, 1959.

5. Dictionary of Personnel and Industrial Relations by Esther L. Becker, New York: Philosophical Library, 1958.

6. Manager Selection, Education and Training by Willard E. Bennet, New York: McGraw Hill and Company, 1959.

7. Essentials of Industrial Management by Lawrence J. Bethel, Franklin S. Atwater, George H. E. Smith, and Harvey A. Stackman, Jr., 2nd ed., New York: McGraw-Hill and Company, 1959.

8. Wage Administration by Charles W. Brennan, Homewood, Illinois: Richard D. Irwin, 1959.

9. Production Handbook by G. B. Carson, 2nd ed., New York: Ronald Publishing Company, 1958.

10. Personnel Management by Herbert J. Chruden and Arther W. Sherman, Cincinnati: South Western Publishing Company, 1959.

11. Executive's Guide to Handling People by Frederick C. Dyer, New York: Prentice-Hall, 1958.

12. Management in Industry by Claude S. George, Jr., Englewood Cliffs: Prentice-Hall, 1959.

13. Management in the Industrial World by Frederick Harbison and Charles A. Meyers, New York: McGraw-Hill, 1959.

14. Personnel Management by Michael J. Jucius, 4th ed., Homewood, Illinois: Richard D. Irwin, 1959.

15. Wage Incentives by J. Keith Londen and J. Wayne Deegan, New York: John Wily and Sons, 1959.

16. Wage and Salary Administration by Lawrence C. Lovejoy, New York: Ronald Press, 1959.

17. Management Training: Cases and Principles by William J. McLarney, 3rd. ed., Homewood, Illinois: Richard D. Irwin, 1959.

18. Public Personnel Administration by Felix A. Nigro, New York: Holt Publishing Company, 1959.

19. Personnel Practices in Colleges and Universities: Faculty and Staff by William D. Poore, College and University Personnel Association, 1958.

20. Readings in Management by Max D. Richards and William A. Nielander, Cincinnati: South Western Publishing Company, 1958.

21. Executive Compensation by David R. Roberts, Glencoe, Free Press, 1959.

Field of Marketing

Marketing Research: Applications, Procedures and Cases, by John P. Alevisos, Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1959, 664 pages -- Parker M. Holmes, Associate Professor.

This book introduces a new approach to the study of Marketing Research. It is essentially a compilation of cases, but provides reasonably adequate descriptive text material upon which case discussion and conclusions can be formulated.

Part I, "Nature and Scope of Marketing Research" (three chapters) is essentially an introduction to the subject, covering the role of marketing research in marketing management, types of marketing research, criteria, and limitations.

Part II, "Marketing Research: Its Procedures, Methods and Techniques" (seven chapters) follows generally accepted standards of procedure constructing the questionnaire, and sampling.

Marketing research procedures and methods are described in Chapter 4. Beginning with Chapter 5, "The Preliminary Investigation," cases are introduced, covering the formulation of the problem, the situation analysis, and defining objectives. Chapter 6, "Planning the Formal Investigation," includes cases on the use of the telephone in conducting surveys, the mail questionnaire, consumer panels, and the use of controlled questionnaires and depth interviewing.

Chapter 7 is devoted to the construction of the questionnaire, with cases on questionnaire techniques, including questionnaires for personal interviewing, observation and mail. Chapter 8, "The Sample," is primarily devoted to probability sampling; in fact, little or no reference is made to non-probability methods that are extensively used in marketing research.

Chapter 9, "Collecting and Processing the Data," includes cases pertaining to interviewing problems, classification of respondents, tabulation of the data, and verification of the sample. Chapter 10, "Preparation and Presentation of the Research Report," is primarily descriptive in nature, dealing with analysis and interpretation of the data, and the formulation of conclusions, as well as with the report form and the construction of tables and charts for the most effective presentation of the data.

Part III includes eight chapters on "Specialized Applications of Marketing Research."

Chapter 11, "Consumer Research," is general in nature, with seven cases illustrative of different kinds of consumer surveys, including LIFE's Study of Consumer Expenditures, brand position and rating studies, impulse buying, consumer finances and intentions to buy.

Chapter 12, "Motivation Research," briefly discusses the major techniques in use and presents three cases for illustrative purposes.

Chapter 13, "Market Analysis," presents the various methods of quantitative analysis, and nine cases pertaining to the establishment of market potentials, four of which are correlation studies. The application of market analysis to retailing and to the marketing problems of distributors is illustrated, as well as its use in establishing market potentials for manufacturers.

Chapter 14, "Sales Analysis and Control," is primarily concerned with the analysis of sales records and market and customer data to provide management with information that will permit more profitable direction of the selling organization and its operations. Three cases are presented.

Chapter 15, "Product Research," includes four cases covering consumer acceptance and evaluation of product designs, price and product design preferences, product research and marketing strategy, and the use of consumer panels in product research.

Chapter 16, "Distribution Cost Analysis," includes cases on size of order cost analysis, channels of distribution, consumer analysis, escapable versus inescapable cost analysis work, and the reduction of distribution costs.

Chapter 17, "Industrial Market Research," includes six cases specifically applicable to this field, which might be more advantageously discussed immediately following Chapter 11, "Consumer Research."

Chapter 18, "Advertising Research," is the last chapter in the book, and might be more appropriately discussed in conjunction with Chapter 12, "Motivation Research." The cases are well selected for their specific purposes, although limited in scope. However, with the introductory text material, the subject is covered in a reasonably satisfactory manner, despite the emphasis of post-testing of advertising.

The major contribution of the author is the provision of a large number of cases (73) that are illustrative of specific areas, methods and techniques of marketing research. The book primarily lends itself for classroom use in one of two ways: (1) as the principal textbook supplemented with assigned readings from other textbooks, periodicals, and/or special publications; (2) as a supplement to a textbook that more fully develops the scope, methods and techniques with which the student must be familiar in order to discuss case studies intelligently.

Fifty Years of Marketing in Retrospect, by Paul D. Converse, Bureau of Business Research, The University of Texas, 1959, 104 pages, $1.50 -- Paul C. Nordloh, Assistant Professor.

In the here and the now, progress inches along so slowly that one is hardly aware of change. Like the mountain climber, it is necessary to look backward to get a true perspective.

As Dr. Converse recalls the past sixty years, marketing literally wore seven league boots. At the turn of the century, salesmen were still drummers. Automobiles were in the experimental stage. Wagon retailers went from house to house selling ice, meats, groceries. Discount houses, scrambled merchandising, gadgeteering, TV spectaculars were not even part of the gossamer of dreams.

As a scholar and writer for almost fifty years, Dr. Paul D. Converse lived through the years he describes. He writes from memory, not from books, although he admits to looking up a few facts.

For those whose life spans the twentieth century, there is a bit of nostalgia as Dr. Converse recalls the passing of the barons, the trust busting, the Model "T", the "disaster" of the $5.00 day. For the present generation, each of the 104 pages is a source of amazement at the climactic changes that sixty years have seen.

Marketing is dynamic. Dr. Converse proves it, as if it needed proving, in a fast moving, easily read, kaleidoscopic account of marketing in the twentieth century.

BIBLIOGRAPHY

1. Profitable Science of Making Media Work by Phillip W. Burton, New London: Printers' Ink, 1959.

2. Retail Advertising and Sales Promotion by R.A. Brown and C. Edwards, New York: Prentice-Hall, 1959.

3. Copy Writing by George T. Clarke, New York: Harper and Brothers, 1959.

4. Marketing Research: Organization and Operation by Richard D. Crisp, American Management Association, 1959.

5. Advertising: Principles and Problems by Charles J. Dirksen and Arthur Kroeger, Homewood, Illinois: Richard Irwin, 1959.

6. Retailing: Principles and Methods by Delbert J. Ducan and Charles F. Phillips, 5th ed., Homewood, Illinois: Richard Irwin, 1959.

7. Operating Results of Food Chains in 1958 by Wilbur B. England, Harvard University, 1959.

8. Salesmanship Fundamentals by John W. Ernest and G. M. Davall, New York: McGraw-Hill Book Company, 1959.

9. Effective Marketing Action by David W. Ewing, ed., New York: Harper and Brothers, 1959.

10. How to Benefit from Data on the Operating Statement, by Irwing Goldenthal, Philadelphia: Chilton, 1959.

11. Retail and Cost Methods Compared by Irwing Goldenthal, Philadelphia, Chilton, 1959.

12. Advertising Agency Success by Kenneth Groesbeck, New York, Harper and Brothers, 1959.

13. How to Sell the Supermarkets by Julian H. Handler, New York: Fairchild, 1959.

14. Explorations in Retailing by Stanley C. Hollander, ed., Michigan State University, Bureau of Research, 1959.

15. Salesmanship and Business Efficiency by James S. and John Knox, Richmond, Virginia: John Knox Press, 1959.

16. Training and Supervising Salesmen by Charles L. Lapp, New York: Prentice-Hall, 1959.

17. Practical Exporting by Philip MacDonald, 2nd ed., New York: The Ronald Press Company, 1959.

18. Operating Results of Department and Specialty Stores in 1958 by Malcon P. McNair, Harvard University, 1959.

19. Economics and Competition in the Transportation Industries by John R. Myer and others, Harvard University, 1959.

20. Handbook of Big-Money Selling Strategies by Charles Roth, New York: Prentice-Hall, 1959.

21. Management of the Sales Forces by William J. Stanton and Richard H. Buskirk, Homewood, Illinois: Richard Irwin, 1959.

22. Tobe Lectures in Retail Distribution, 1958-1959, Harvard University, 1959.

23. Sales Promotions that Get Results by Howard M. Turner, New York: McGraw-Hill Book Company, 1959.

24. 100 Greatest Advertisements by Julian L. Watkins, 2nd. ed. rev. ed., Collegeville, Minnesota: Dover, 1959.

PUBLICATIONS AVAILABLE THROUGH
MARQUETTE UNIVERSITY
BUREAU OF BUSINESS AND ECONOMIC RESEARCH

MARQUETTE BUSINESS REVIEW
(5 issues annually) ..... $2.00 per year

A SURVEY OF MILWAUKEE'S ADVERTISING MEN AND WOMEN TO DETERMINE THEIR BACKGROUND AND OPINIONS ON MODERN EDUCATION FOR ADVERTISING - 1959 ..... 2.00

THE OFFICE MANAGER: RESPONSIBILITIES AND PERSONAL CHARACTERISTICS - A Study of 134 Members of the Milwaukee Chapter of the National Office Management Association - 1959 ..... 5.00

RETIREMENT PLANS IN MILWAUKEE COUNTY, WISCONSIN - A Study of 1,292 Units Employing 172,203 Persons - 1957 ..... 3.00

RULES OF EVIDENCE APPLICABLE IN PROCEEDINGS BEFORE THE TAX COURT OF THE UNITED STATES: BURDEN OF PROOF AND PRESUMPTION - 1957 ..... 1.00

A SURVEY AND EVALUATION OF COMPANY APPROACHES TO ELECTRONIC DATA PROCESSING - A Study of the Problems of Computer Installation as Reported by 61 Companies 4.00

ADVERTISING AND MARKETING TO MEET TODAY'S ECONOMIC CHALLENGE AND OPPORTUNITY - Proceedings of the Fourth Marquette University Advertising Conference - 1958 ..... 3.00

NEW UNDERSTANDING IN AGENCY-CLIENT RELATIONSHIPS - Proceedings of the Third Marquette University Advertising Conference - 1957 ..... 2.50

HOW THE PUBLIC LOOKS AT MANAGEMENT PROBLEMS - 1954-1955 ..... 1.00

SELLING THE INDUSTRIAL MARKET TODAY - A Joint Study by Marquette University and by Newsweek Magazine - 1953 ..... 1.00

MARQUETTE UNIVERSITY INSTITUTES ON TAXATION - Volumes 1 through 6, Years 1950 through 1956 .. 7.50 each